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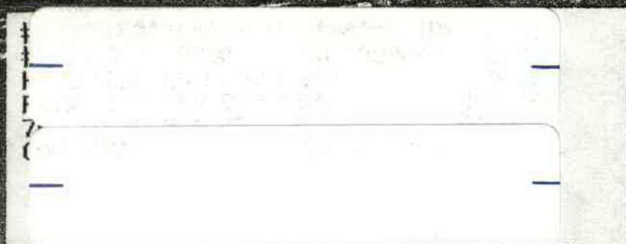
Why Companies Fail



10 Fatal Mistakes
(and how to avoid them)

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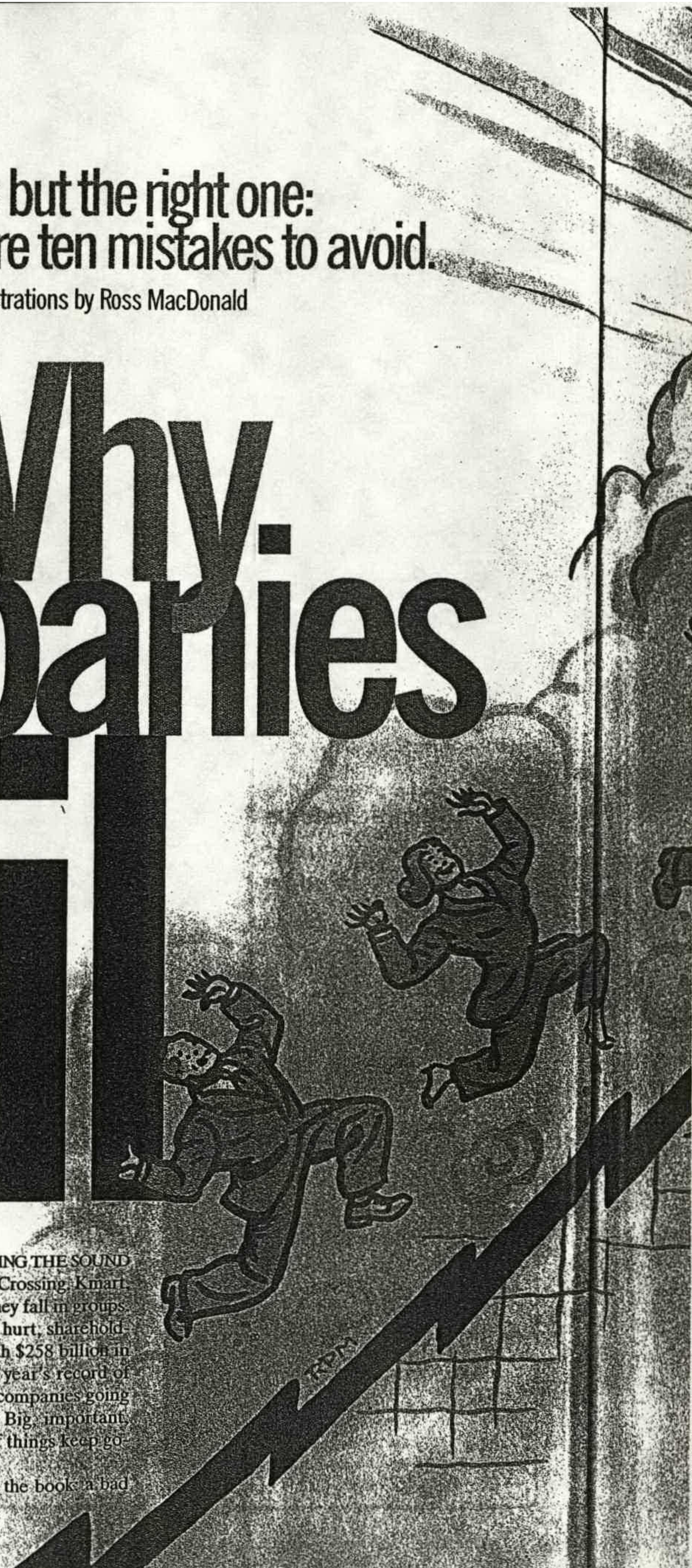
CEOs offer every excuse but the right one: their own errors. Here are ten mistakes to avoid.

by Ram Charan and Jerry Useem illustrations by Ross MacDonald

Why companies fail



HOW MANY MORE MUST FALL? EACH MONTH SEEMS TO BRING THE SOUND of another giant crashing to earth. Enron. WorldCom. Global Crossing. Kmart. Polaroid. Arthur Andersen. Xerox. Qwest. They fall singly. They fall in groups. They fall with the heavy thud of employees laid off, families hurt, shareholders furious. How many? Too many; 257 public companies with $258 billion in assets declared bankruptcy last year, shattering the previous year's record of 176 companies and $95 billion. This year is on pace, with 67 companies going bust during the first quarter. And not just any companies. Big, important, FORTUNE 500 companies that aren't supposed to collapse. If things keep going like this, we may have trouble filling next year's list.

Why do companies fail? Their CEOs offer every excuse in the book: a bad

Fearing the boss too much ...

economy, market turbulence, a weak yen, hundred-year floods, perfect storms, competitive subterfuge—forces, that is, very much outside their control. In a few cases, such as the airlines' post-Sept. 11 problems, the excuses even ring true. But a close study of corporate failure suggests that, acts of God aside, most companies founder for one simple reason: managerial error.

We'll get to the errors in a moment. But first let's acknowledge that, yes, failures usually involve factors unique to a company's own industry or culture. As Tolstoy said of families, all happy companies are alike; every unhappy company is unhappy in its own way. Companies even collapse in their own way. Some go out in blinding supernovas (Enron). Others linger like white dwarfs (AT&T). Still others fizzle out over decades (Polaroid). Failure is part of the natural cycle of business. Companies are born, companies die, capitalism moves forward. Creative destruction, they call it.

It was roughly this sentiment that Treasury Secretary Paul O'Neill was trying to convey when he said that Enron's failure was "part of the genius of capitalism." But aside from sounding insensitive, O'Neill got one thing wrong. Capitalism's true genius is to weed out companies that no longer serve a useful purpose. The dot-coms, for instance, were experiments in whether certain businesses were even viable. We found out: They weren't. Yet many recent debacles were of companies that could have lived long, productive lives with more enlightened management—in other words, good companies struck down for bad reasons. By these lights, Arthur Andersen's fall is no more part of the "genius of capitalism" than the terrorism on Sept. 11 was part of the "genius of evolution."

Joseph Berardino, former CEO of Arthur Andersen

DOUGLAS GRAHAM—CORBIS SYGMA

By "failure," we don't necessarily mean bankruptcy. A dramatic fall from grace qualifies too. In the most recent bear market, for instance, 26 of America's 100 largest companies lost at least two-thirds of their market value, including such blue chips as Hewlett-Packard, Charles Schwab, Cisco, AT&T, AOL Time Warner, and Gap. In the 1990 bear market, by contrast, none did, according to money management firm Aronson & Partners.

The sheer speed of these falls has been unnerving. Companies that were healthy just moments ago,

DOUGLAS GRAHAM—CORBIS SYGMA

... and the competition not enough

Even when a boss doesn't intend to quash dissent, subtle signals can broadcast the message that bad news is not welcome.

it seems, are suddenly at death's door. But this impression may be misleading. Consider, for instance, a certain Houston institution we've heard so much about. There was no one moment when its managers sat down and conspired to commit wrongdoing. Rather, the disaster occurred because of what one analyst calls "an incremental descent into poor judgment." A "success-oriented" culture, mind-numbing complexity, and unrealistic performance goals all mixed until the violation of standards *became* the standard. Nothing looked amiss from the outside until, boom, it was all over.

It sounds a lot like Enron, but the description actually refers to NASA in 1986, the year of the space shuttle *Challenger* explosion. We pull this switch not to conflate the two episodes—one, after all, involved the death of seven astronauts—but to make a point about failures: Even the most dramatic tend to be years in the making. At NASA, engineers noticed damage to the crucial O-rings on previous shuttle flights yet repeatedly convinced themselves the damage was acceptable. Companies fail the way Ernest Hemingway wrote about going broke in *The Sun Also Rises*: gradually, and then suddenly. (For some solutions, see box "Three Quick Fixes.")

What undoes them is the familiar stuff of human folly: denial, hubris, ego, wishful thinking, poor communication, lax oversight, greed, deceit, and other *Behind the Music* plot conventions. It all adds up to a failure to execute. This is not an exhaustive list of corporate sins. But chances are your company is committing one of them right now.

Softened by success

"Those whom the gods would destroy," Euripides wrote nearly 2,500 years ago, "they first make mad." In the modern update,

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RAM CHARAN *advises* FORTUNE *500 CEOs and is co-author, with Larry Bossidy, of* Execution: The Discipline of Getting Things Done, *to be published in June.*

the gods send their victims 40 years of success. Actually, it's a proven fact: A number of studies show that people are less likely to make optimal decisions after prolonged periods of success. NASA, Enron, Lucent, WorldCom—all had reached the mountaintop before they ran into trouble. Someone should have told them that most mountaineering accidents happen on the way down.

> **Says an ex-Xerox executive: "I could not present to the board unless things were perfect. Everything had to be prettied up."**

Consider the case of Cisco Systems. While by no means a failure, Cisco suffered a remarkable comedown in the spring of 2001—remarkable not only for its swiftness (its shares lost 88% of their value in one year) but also because Cisco, more than any other company, was supposed to be able to see into the future. The basis of this belief was a much vaunted IT system that enabled Cisco managers to track supply and demand in "real time," allowing them to make pinpoint forecasts. The technology, by all accounts, worked great. The forecasts, however, did not. Cisco's managers, it turned out, never bothered to model what would happen if a key assumption—growth—disappeared from the equation. After all, the company had recorded more than 40 straight quarters of growth; why wouldn't the future bring more of the same?

The rosy assumptions, moreover, persisted even when evidence to the contrary started piling up. Customers began going bankrupt. Suppliers warned of a coming dropoff in demand. Competitors stumbled. Even Wall Street wondered if the Internet equipment market was falling apart. "I have never been more optimistic about the future of our industry as a whole or of Cisco," CEO John Chambers declared in December 2000, still projecting 50% annual growth.

What was Chambers thinking? In *The Challenger Launch Decision*, her definitive book on the disaster, Boston College sociologist Diane Vaughan notes that people don't surrender their mental models easily. "They may puzzle over contradictory evidence," she writes, "but usually succeed in pushing it aside—until they come across a piece of evidence too fascinating to ignore, too clear to misperceive, too painful to deny, which makes vivid still other signals they do not want to see, forcing them to alter and surrender the world-view they have so meticulously constructed."

For the perpetually sunny Chambers, that "piece of evidence" did not come until April 2001, when cratering sales forced Cisco to write down $2.5 billion in excess inventory and lay off 8,500 employees. Chambers may have been operating in real time, but he wasn't operating in the real world.

Ten big mistakes

They are the standard stuff of corporate folly. Chances are, your company has made at least one.

	Slave to Wall Street	See no evil	Overdosing on risk	Dysfunctional board	Softened by success	Strategy du jour	Acquisition lust	Fearing the boss	Dangerous culture	Death spiral
◆ Enron	●	●	●	●	●			●	●	●
Arthur Andersen		●	●						●	●
◆ Global Crossing	●	●	●	●						
Lucent	●		●	●	●					
◆ Warnaco	●	●		●				●		
◆ Kmart		●		●		●				
Providian	●		●		●					
◆ Sunbeam	●	●						●		
Tyco	●					●	●			
WorldCom			●		●		●			
Xerox	●	●		●						
AT&T						●	●			
◆ Polaroid		●			●					
Qwest	●		●							

◆ Filed for bankruptcy.

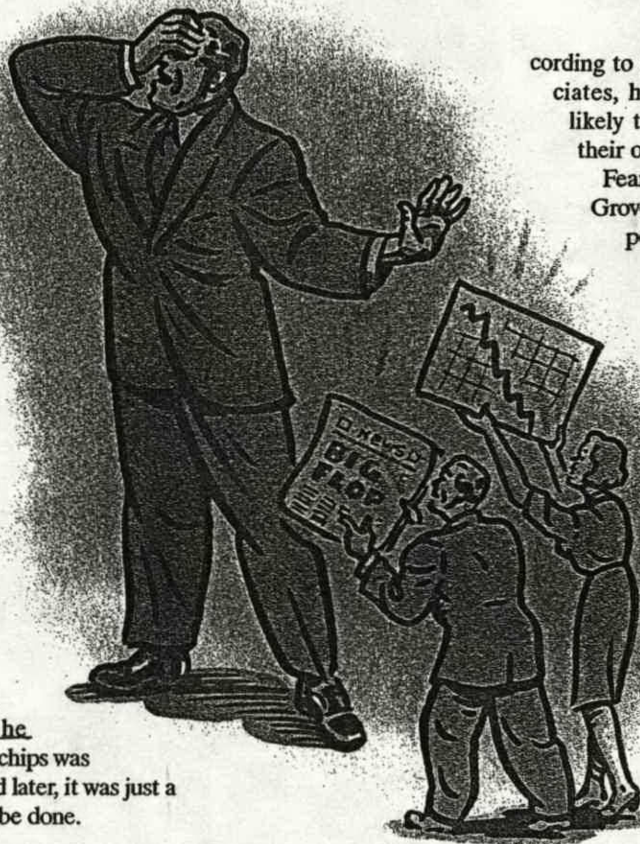
FORTUNE TABLE

See no evil

With $6.5 billion in cash and a strong competitive position, Cisco will live to fight another day. Polaroid may not be so lucky. Like its fellow old-economy stalwart Xerox, Polaroid was a once-highflying member of the Nifty Fifty group of growth stocks that lost their luster over the years. Eventually the question "What does Polaroid make?" became a latter-day version of "Who's buried in Grant's tomb?" Polaroid, that is, made Polaroid cameras—period.

Time had passed the company by, you might say. Not exactly. Think about

another company that once seemed doomed to fail: Intel. Back in 1985, competition from Japan was turning Intel's memory chips into cheap commodities, and observers were all but writing the company's obituary. Instead of going the way of Polaroid, though, Intel decided to exit the memory business entirely and become a maker of microprocessors. The key insight occurred when Intel founders Andy Grove and Gordon Moore sat down and asked themselves some tough questions. "If we got kicked out and the board brought in a new CEO," Grove asked Moore, "what do you think he would do?" Get out of memory chips was the answer. From there, they said later, it was just a matter of doing what needed to be done.



cording to a study by Goleman and two associates, higher-ranking executives are less likely to have an accurate assessment of their own performance.

Fear can have its uses, of course; Andy Grove has long espoused the value of competitive paranoia. But in unhealthy situations, employees come to worry more about internal factors—what the boss might say, what management might do—than about threats from the outside world. Certainly this was the case at Enron, where even alarm-ringer Sherron Watkins chose to express her concerns anonymously rather than hazard one of CEO Jeff Skilling's famous tongue-lashings. And she was one of the brave ones.

The same problem hampered Samsung Chairman Lee Kun Hee in 1997 when he decided to take Samsung into the auto business. Knowing the car industry was a crowded field plagued by overcapacity, many of Samsung's top managers silently opposed the $13 billion investment. But Lee was a forceful chairman and a car buff to boot. So when Samsung Motors folded just a year into production, forcing Lee to spend $2 billion of his own money to placate creditors, he expressed surprise: How come nobody had spoken up about their reservations?

Polaroid and Xerox, by contrast, were slow to confront the changing world around them. Executives at both companies repeatedly blamed poor results on short-term factors—currency fluctuations, trouble in Latin America—rather than the real cause: a bad business model. By the time Xerox President (and now CEO) Anne Mulcahy came out and spoke the truth—the company had "an unsustainable business model," she told analysts in 2000—Xerox was flirting with bankruptcy.

Avoiding the brutal facts

During World War II, Churchill set up an office outside the chain of command whose main job was to tell him the unvarnished truth.

Jim Collins, author of the influential management books *Built to Last* and *Good to Great*, has spent years studying what separates great companies from mediocre ones. "The key sign—*the* litmus test—is whether you begin to explain away the brutal facts rather than to confront the brutal facts head-on," he says. "That's sort of the pivot point." By forcing themselves to think like outsiders, Grove and Moore recognized the brutal facts before it was too late. Polaroid and Xerox didn't.

Fearing the boss more than the competition

Sometimes CEOs don't get the information they need to make informed decisions. The main reason, says Daniel Goleman, a psychologist and author of the book *Primal Leadership*, is that subordinates are afraid to tell them the truth. Even when a boss doesn't intend to quash dissent, subtle signals—a sour expression, a curt response—can broadcast the message that bad news isn't welcome. That's why, ac-

Bernard Ebbers, former CEO of WorldCom

BRENT STIRTON—LIAISON

During World War II, Winston Churchill worried that his own larger-than-life personality would deter subordinates from bringing him bad news. So he set up a unit outside his generals' chain of command, the Statistical Office, whose primary job was to feed him the starkest, most unvarnished facts. In a similar vein, Richard Schroth and Larry Elliott, authors of the forthcoming book *How Companies Lie*, suggest designated "counterpointers," whose function is to ask the rudest questions possible. Such mechanisms take information and turn it into information that can't be ignored.

Overdosing on risk

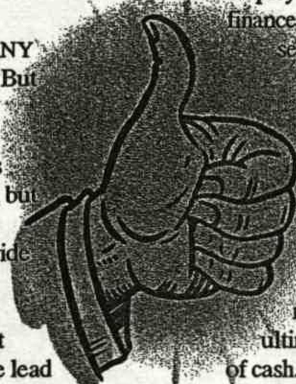
Some companies simply live too close to the edge. Global Crossing, Qwest, 360networks—these telecom flameouts chose paths that were not just risky but wildly imprudent. Their key mistake: loading up on two kinds of risk at once.

The first might be called "execution risk." In their race to band the earth in optical fiber, the telco up-

starts ignored some key questions: Namely, would anyone need all of this fiber? Weren't there too many companies doing the same thing? Wouldn't, uh, most of them fail? "People seemed to say, 'Maybe—but it's not going to be us,'" says Darrell Rigby, a Bain & Co. consultant who studies managing during times of turbulence. "Everyone thought they were immune."

On top of execution risk was another kind, which we'll call liquidity risk. Global Crossing—run by Gary Winnick, formerly of the junk-bond house Drexel Burnham Lambert—loaded up on $12 billion of high-yield debt. This essentially limited Winnick to

Three quick fixes



THE RECENT CORPORATE COLLAPSES HAVE INVOLVED MANY breakdowns: in ethics, in trust, in common sense, to name a few. But perhaps the most troubling breakdown is in corporate oversight. Directors, senior executives, and Wall Street analysts all failed miserably by missing—or concealing—danger signals until it was too late. Regulators will no doubt have plenty to say on the issue, but the most zealous reformers should be the companies themselves. They can begin with three changes that, taken together, will provide a better early-warning system against failure:

1 Reengineer the board. Remember reengineering? It was applied to every corner of the corporation at one point or another—except the board. That needs to change. Incompetence is not the problem. Boards can be full of very capable people yet be totally ineffective as a group. The problem is that directors are too nice. Boards seldom convene without the CEO, and raising troubling questions can simply seem rude—which is often the way the CEO wants it. Directors need a forum where they can talk frankly *without* the CEO. Ten minutes at the end of each meeting would be a good start. Better yet, an annual retreat where the board can assess its own performance as well as the CEO's. Collectively, the directors are supposed to serve as a company's peripheral vision. Often at least one director suspects trouble before it becomes a crisis. The trick is getting him or her to say it out loud.

Boards should also appoint the chairperson of the governance committee as lead director. This especially makes sense when the CEO and chairman are the same person, as is the case with most U.S. companies. The lead director would be from the outside, reappointed every two years or so, and authorized to convene a meeting anytime, any place, with or without management.

2 Turn employees into corporate governors. As the Enron debacle has proven, regular employees—not executives, not directors, not shareholders—have the most to lose when a company fails. With their jobs, pensions, and stock-option wealth on the line, it follows that they have a greater incentive than anyone to act as company watchdogs. Yet few companies tap this built-in alarm system. Too often, front-line employees smell something rotten but do not, or cannot, convey the message upward. That's why companies need a mechanism to make it happen.

Whistle-blowing does not count as a mechanism. Whistle-blowing is a last resort—one that's frequently harmful to the whistle blower's health. What's really needed is a survey, carefully designed and administered by an outside agency, that regularly solicits employee feedback on sensitive questions. Do people trust management? Is there any reason to doubt the reported revenue numbers? Are the company's values out of whack? Think of it as a human audit. Send the results directly to the board. And give employees a chance to inspect company finances directly—say, by holding Q&A sessions with the CFO. Corporate governance should ideally include all a company's stakeholders, and employees hold the biggest stake of all.

3 Banish Ebitda. Companies hit the skids for all sorts of reasons, but it's one thing that ultimately kills them: They run out of cash. Yet most managers are too preoccupied with measures like Ebitda (earnings before interest, taxes, debt, and amortization) and return on assets to give cash much notice. Boards don't ask for it. Analysts don't analyze it. Corporate financial statements do typically include a statement of cash flow, but it's a crude snapshot that excludes off-balance-sheet items and doesn't show where the cash comes from. The solution is a detailed, easily readable cash-flow report. Give it to the board. Give it to employees. Break out cash flow by division, letting people track the company's blood flow themselves. Warren Buffett pays close attention to cash flow because, among other reasons, he knows cash is hard to fudge. That's why creative accountants hate it—and why you should learn to love it.

No system survives for long without feedback and controls. So corporate America has a choice: It can implement these controls itself. Or it can wait for regulators and politicians to impose them. Which sounds better to you?

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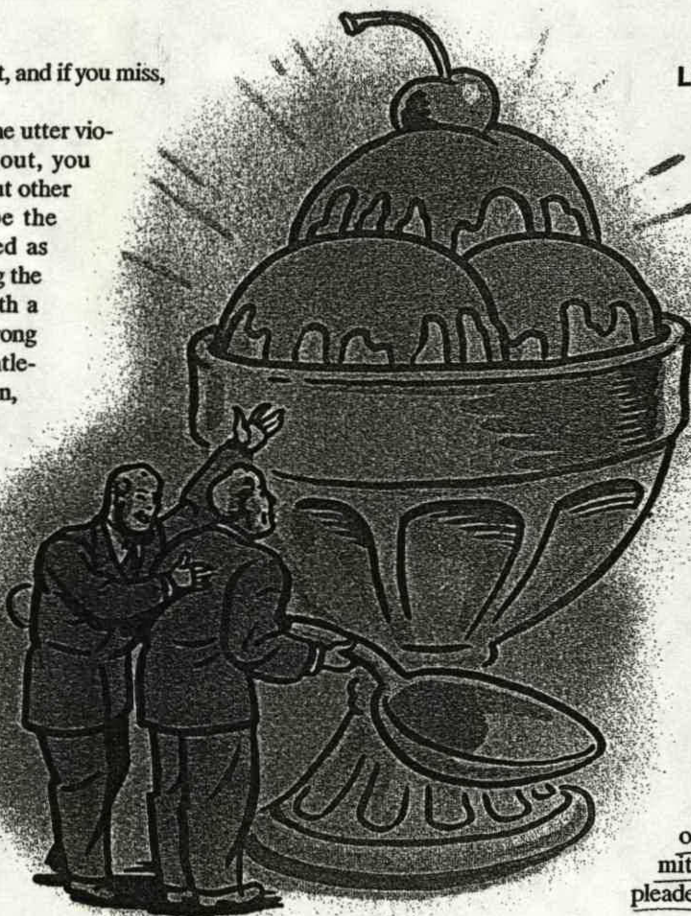
a cannonball strategy: one shot, and if you miss, it's bankruptcy.

Bankruptcy it was. Given the utter violence of the telecom shakeout, you might say it was inevitable. But other telcos did manage to escape the carnage. BellSouth, dismissed as hopelessly conservative during the Wild West years, emerged with a pristine balance sheet and a strong competitive position. Its gentlemanly CEO, Duane Ackerman, was guided by a radical idea: "being good stewards of our shareholders' money." What a concept.



Eyes bigger than ...

Ebbers liked to eat. He ate MCI. He ate MFS. Wall Street helped him wash it all down with cheap capital and a soaring stock.

Acquisition lust

WorldCom founder Bernard Ebbers liked to eat. He ate MCI. He ate MFS and its UUNet subsidiary. He tried to eat Sprint. Wall Street helped him wash it all down with cheap capital and a buoyant stock price. Pretty soon WorldCom was tipping the scales at $39 billion in revenues. But there was a problem: Ebbers didn't know how to digest the things he ate. A born dealmaker, he seemed to care more about snaring new acquisitions than about making the existing ones—all 75 of them—work together. At least Ebbers was up front about it: "Our goal is not to capture market share or be global," he told a reporter in 1997. "Our goal is to be the No. 1 stock on Wall Street."

The results were frequently chaotic. For a time, sales reps from UUNet competed head-to-head with WorldCom sales teams for corporate telecom contracts. Smaller customers complained they had to call three different customer-service reps for their Internet, long-distance, and local-phone inquiries. If there is such a thing as negative synergy, WorldCom may have discovered it.

Not that acquisitions are always so bad. General Electric combines its acquisitive nature with an impressive ability to break down acquisitions and integrate them into existing operations. But too often CEOs succumb to an undisciplined lust for growth, accumulating assets for the sake of accumulating assets. Why? It's fun. There are lots of press conferences. It's what powerful CEOs do. And like Ebbers, whose WorldCom stock has lost 98% of its value, few wonder if their eyes might be bigger than their stomachs.

REPORTER ASSOCIATE *Ann Harrington*

Listening to Wall Street more than to employees

No one likes a good growth story better than Wall Street. And in the late 1990s, no one was telling a better one than Lucent CEO Rich McGinn. He knew how to give Wall Street what it wanted—explosive top-line growth—and in return, Wall Street turned McGinn and his team into rock stars. For a bunch of former Bellheads, it was intoxicating stuff.

But while McGinn was busy performing for the Street, there were at least two groups he wasn't listening to. The first was Lucent's scientists, who feared the company was missing out on a new optical technology, OC-192, that could transmit voice and data faster. They pleaded in vain for its development, then watched as rival Nortel rolled out OC-192 gear to thunderous success. At the same time McGinn was neglecting Lucent's salespeople, who might have told him that his growth targets were becoming increasingly unrealistic. To meet them, employees were pulling forward sales from future quarters by offering steep discounts and wildly generous financing arrangements, largely to dot-coms. "As we got further and further behind," Chairman Henry Schacht later explained, "we did more and more discounting."

It could only last so long. After Lucent stock had lost more than 80% of its value and he had replaced McGinn as CEO, Schacht sat down with FORTUNE to ponder some hard-earned lessons. "Stock price is a byproduct; stock price isn't a driver," he said. "And every time I've seen any of us lose sight of that, it has always been a painful experience." Top management needs to understand what the folks on Wall Street want—but not necessarily give it to them.

Strategy du jour

When companies run into trouble, the desire for a quick fix can become overwhelming. The frequent result is a dynamic that Collins describes in *Good to Great*: "A&P vacillated, shifting from one strategy to another, always looking for a single stroke to quickly solve its problems. [It] held pep rallies, launched programs, grabbed fads, fired CEOs, hired CEOs and fired

them yet again." Lurching from one silver bullet solution to another, the company never gained any traction.

Collins calls it the "doom loop," and it's a killer. Kmart is another victim. In the 1980s and early '90s, Kmart was all about diversification, shifting away from discounting to acquire stakes in chains like Sports Authority, OfficeMax, and Borders bookstores. But in the 1990s a new management team divested those stores and decided to revamp Kmart's supply chain by investing heavily in IT. That lasted for a while, until a new CEO, Chuck Conaway, decided that, actually, Kmart would try to beat Wal-Mart at its own game. This unleashed a disastrous price war that in the end proved to be one mistake too many. "When you look at companies that get themselves into trouble," says Collins, "they're often taking steps of great, lurching bravado rather than quiet, deliberate understanding." Did somebody say AT&T?

"The great companies don't make excuses," said Treasury Secretary Paul O'Neill recently. "They do well anyway."

Gary Winnick, chairman of Global Crossing

A dangerous corporate culture

Arthur Andersen, Enron, and Salomon Brothers were all brought down, or nearly so, by the rogue actions of a tiny few. But the bad apples in these companies grew and flourished in the same kind of environment: a rotten corporate culture. It's impossible to monitor the actions of every employee, no matter how many accounting and compliance controls you put in place. But either implicitly or explicitly, a company's cultural code is supposed to equip front-line employees to make the right decisions without supervision. At Salomon Brothers the culture did just the opposite. The transgressor there was Paul Mozer, a trader who in February of 1991 improperly overbid in auctions of U.S. Treasury bonds. While it was another improper bid on May 22 that finally did him in, the critical event occurred in April, when Salomon Chairman John Gutfreund learned of the February overbid by Mozer and failed to discipline him. Mozer evidently took Gutfreund's lack of action as a green light.

Salomon's culture of swashbuckling bravado encouraged risk taking without accountability. Enron's culture encouraged profit taking without disclosure. Andersen's culture engendered conflicts of interest without safeguards. Rotten cultures produce rotten deeds.

The new-economy death spiral

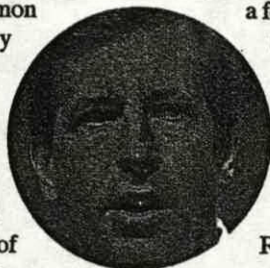
Alan Greenspan has his own theory on failure. Testifying about Enron in February, he noted, "A firm is inherently fragile if its value-added emanates more from conceptual as distinct from physical assets.... Trust and reputation can vanish overnight. A factory cannot." The speed of some recent crack-ups would seem to confirm his thesis. The first domino falls when questions are raised, sometimes anonymously. Wrongdoing is suspected. Customers delay new orders. Rating agencies lower their debt ratings. Employees head for the exits. More customers defect. And *voilà*, you have what former Enron CEO Jeff Skilling has called "a classic run on the bank."

Is it possible to halt one? Yes, but only if you stop the spiral from building up speed. Salomon broke the cycle by hiring Warren Buffett as interim CEO—essentially a giant credibility infusion. By waiting several months to step down, on the other hand, Arthur Andersen CEO Joseph Berardino lost whatever chance he had to avoid disaster. Once started, the spiral can bring a company whose main assets are people and ideas to its knees with breathtaking finality.

A dysfunctional board

What was Enron's board thinking? Of all the infamous moments in the company's demise, perhaps the least explicable was the board's decision to waive Enron's code of ethics to accommodate CFO Andrew Fastow's partnerships. "A red flag the size of Alaska," says Nell Minow, founder of the board watchdog group Corporate Library. Even Enron directors belatedly agreed with this assessment. "After having authorized a conflict of interest creating as much risk as this one," the board's special investigation committee wrote in a February report, "the board had an obligation to give careful attention to the transactions that followed. It failed to do this.... In short, no one was minding the store."

Despite a decade's worth of shareholder activism, Enron's board was not an anomaly. The sorry fact is that most corporate boards remain hopelessly beholden to management. "I was never allowed to present to the board unless things were perfect," says a former senior executive at Xerox, whose board includes Vernon Jordan and former Senator George Mitchell. "You could only go in with good news. Everything was prettied up." At many boards, the CEO oversees meetings, hand-picks directors, and spoon-feeds them information. "Directors know relatively little apart from what management tells them," says John Smale, a former CEO of Procter & Gamble and onetime chairman of General Motors.



Charles Conaway, former CEO of Kmart

Unless, that is, the board demands more. "The CEO is always going to want to turn the board meeting into a pep rally," says Minow. "You've got to say to him, 'Look, I'm a busy person. I don't have time for the good news. What I need for you to tell me is the bad news.' It's like what Robert Duvall says in *The Godfather*: 'I have to go to the airport. The Godfather is a man who likes to hear bad news immediately.' That should be emblazoned on every corporate governance policy sheet."

Paul O'Neill may have been wrong about his assessment of Enron, but he was right about something else. "The great companies don't make excuses," he said recently, "including excuses about how they didn't do well because the economy was against them or prices were not good. They do well anyway." It's true. And it's something to think about the next time you hear a CEO railing at the gods. ■

FEEDBACK *juseem@fortunemail.com*

TOP: JAMES LEYNSE—CORBIS SABA; BOTTOM: AP

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